

## Message Text

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INFO OCT-01 ISO-00 AID-05 CEA-01 CIAE-00 COME-00 EB-07

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PASS CEA, TREASURY, FRB

E.O.11652: N/A

TAGS: ECON, OECD

SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE (EDRC)

REVIEW OF PORTUGAL

REF: EDR(76)26

1. SUMMARY: FRUITFUL DISCUSSION OF PORTUGUESE SHORT-TERM AND MEDIUM-TERM PROSPECTS AND POLICIES AT OCTOBER 20 EDRC REVIEW WAS IN LARGE PART DUE TO WELL-PREPARED AND INFORMATIVE PRESENTATION BY PORTUGUESE DEL (LED BY CONSTANCIO) AND TO LATTER'S FRANK AND DIRECT RESPONSES TO QUESTIONS POSED BY SECRETARIAT AND BY COUNTRY DELS. PORTUGUESE AGREED (WITH SOME QUALIFICATIONS) WITH THRUST OF REFDOC THAT POLICIES MUST BE AIMED AT SUPPRESSING INFLATION, REDUCING PUBLIC AND PRIVATE CONSUMPTION, AND SHIFTING RESOURCES INTO INVESTMENT AND EXPORTS. HOWEVER, PORTUGUESE STRESSED THAT THESE NECESSARY SHIFTS

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SHOULD BE EFFECTED IN FRAMEWORK OF REASONABLY STRONG GDP

GROWTH, AND THUS REJECTED OVERALL DEFLATION AS MEANS TO THESE ENDS. FURTHERMORE, PORTUGUESE EMPHASIZED THAT INCREASE IN INVESTMENT WOULD REQUIRE LARGER PROFITS THROUGH A LIBERALIZATION OF PRICE CONTROLS WITH IMPLIED ACCELERATION OF INFLATION. THUS, PORTUGUESE DID NOT SEE ERADICATION OF INFLATION AS FIRST-ORDER PRIORITY FOR THE IMMEDIATE TERM. PORTUGUESE STATED VIEW THAT IMMEDIATE ADOPTION OF EXCHANGE RATE FLEXIBILITY AND INCREASE IN NOMINAL INTEREST RATES WOULD PRODUCE MINIMAL SHORT-RUN BENEFITS. AFTER LENGTHY, BUT NON-CONTENTIOUS DISCUSSION OF THESE ISSUES, SECRETARIAT AND PORTUGUESE AGREED THAT REFDOC WOULD BE REDRAFTED SO AS TO PLACE RECOMMENDATIONS FOR EXCHANGE RATE FLEXIBILITY AND INCREASE IN NOMINAL INTEREST RATES MORE CLEARLY IN MEDIUM-TERM CONTEXT AS APPROPRIATE MEASURES TO REDUCE STRUCTURAL IMBALANCES AND TO MOVE PORTUGUESE ECONOMY TOWARD MORE MARKET-DETERMINED ALLOCATION OF RESOURCES. PORTUGUESE DID NOT EXPRESS EXTREME CONCERN WITH RESPECT TO SHORT-TERM EXTERNAL FINANCING PROSPECTS, BUT INDICATED AT SEVERAL POINTS THAT CURRENT ACCOUNT DEFICIT OF REASONABLE SIZE APPROPRIATE FOR PORTUGAL AND THAT NEED FOR FINANCIAL ASSISTANCE FROM ABROAD WOULD CONTINUE IN MEDIUM TERM. EDRC AGREED WITH U.S. SUGGESTION THAT CONCLUSIONS OF SURVEY SHOULD BE AMPLIFIED TO NOTE SIGNIFICANT PROGRESS PORTUGAL HAS MADE UNDER EXTREMELY ADVERSE CIRCUMSTANCES, AND TO ENCOURAGE IT TO PERSEVERE ON THE LONG ROAD BACK TO ECONOMIC STABILITY. END SUMMARY.

2. SHORT-TERM PROSPECTS; DOMESTIC OUTLOOK: PORTUGUESE FELT THAT SECRETARIAT HAD UNDERESTIMATED STRENGTH OF PORTUGUESE RECOVERY IN 1976. HOWEVER, DIFFERENCES BETWEEN SECRETARIAT AND PORTUGUESE FORECASTS WERE MORE APPARENT THAN REAL. SECRETARIAT DID NOT QUESTION PORTUGUESE ASSERTION THAT PUBLIC CONSUMPTION AND EXPORT GROWTH HAD BEEN STRONGER THAN EXPECTED THUS FAR IN 1976, AND BOTH PARTIES AGREED THAT REAL PRIVATE CONSUMPTION AND INVESTMENT WOULD STAGNATE THIS YEAR. PORTUGUESE INDICATED THAT REAL GDP GROWTH COULD BE AS HIGH AS 5 PERCENT IN 1976, BUT SEE 3 PERCENT AS MOST LIKELY OUTCOME. SECRETARIAT DID NOT DISAGREE WITH PORTUGUESE LIMITED OFFICIAL USE

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ASSESSMENT.

3. PRICES: PORTUGUESE EXPECT PRICES TO INCREASE BY ABOUT 20 PERCENT IN 1976. WHILE NOTING "MEASURED" RATE OF INFLATION, PORTUGUESE FOCUSED ON SUBSTANTIAL DEGREE OF "SUPPRESSED INFLATION" RESULTING FROM MAINTENANCE OF PRICE CONTROLS IN FACE OF SHARPLY-RISING PRODUCTION COSTS. BY END OF EDRC MEETING, PORTUGUESE DEL WAS

OPENLY UNDERSCORING NEED TO EXPAND BUSINESS PROFITS AS  
PRECONDITION FOR INCREASE IN PRIVATE INVESTMENT. HE  
APPROACHED USE OF TERM "PROFITS" GRADUALLY DURING COURSE  
OF MEETING BY REFERRING VARIOUSLY TO NEED TO ESTABLISH  
PROPER "WORKING CONDITIONS"; TO ELIMINATE "SUPPRESSED  
INFLATION"; AND TO BRING ABOUT "PROPER RELATION BETWEEN  
PRICES AND COSTS." PORTUGUESE SAID THAT RESTORATION OF  
BUSINESS PROFITABILITY WOULD REQUIRE LIBERALIZATION OF  
PRICE CONTROLS, WHICH WAS INCONSISTENT WITH SECRETARIAT

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VIEW THAT REDUCTION OF INFLATION SHOULD BE URGENT AND  
IMMEDIATE OBJECTIVE FOR GOP. NEITHER SECRETARIAT NOR  
EDRC DISAGREED.

4. WAGES: PORTUGUESE EMPHASIZED THAT SUBSTANTIAL PRO-  
GRESS HAD BEEN MADE IN REDUCING GROWTH OF NOMINAL INCOMES,  
AND NOTED THAT REAL WAGES HAD ACTUALLY DECLINED IN FIRST

HALF OF 1976. DESPITE THEIR DISAGREEMENT WITH SECRETARIAT ON PRIORITY WHICH SHOULD BE ASSIGNED TO TASK OF GETTING INFLATION DOWN, PORTUGUESE RECOGNIZED THAT BALANCED ECONOMIC GROWTH OVER MEDIUM TERM WOULD BE IMPOSSIBLE IF INFLATION WERE TO CONTINUE UNABATED. PORTUGUESE INTEND TO RELY ON INCOMES POLICY RATHER THAN ON DEMAND MANAGEMENT POLICY TO RESTRAIN GROWTH OF WAGES AND PRICES. THEY NOTED THAT WAGE INCREASES WOULD BE NEGOTIATED IN FRAMEWORK OF A TRIPARTITE COMMISSION (BUSINESS, GOP, LABOR) SOON TO BE ESTABLISHED, BUT THAT PARAMETERS OF PLANNED INCOMES POLICY (E.G. WHETHER LIMITED OFFICIAL USE

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LIMITATIONS ON WAGE INCREASES WOULD BE BINDING) HAD NOT YET BEEN FIXED. PORTUGUESE DID NOT EXPRESS VIEW ON WHAT RATE OF WAGE RESTRAINT WHICH THEY COULD REALISTICALLY EXPECT TO ACHIEVE IN 1977 OR WOULD CONSIDER CONSISTENT WITH OVERALL ECONOMIC STABILITY.

5. UNEMPLOYMENT: PORTUGUESE PLACE CURRENT UNEMPLOYMENT RATE AT 10-15 PERCENT OF LABOR FORCE, AND ESTIMATE TOTAL NUMBER UNEMPLOYED TO BE ABOUT 450,000. U.S. DELOPOINTED TO SUBSTANTIAL PROGRESS GOP HAS MADE IN RESTORING DISCIPLINE TO LABOR MARKET, AND NOTED THAT PASSAGE OF LAW ON GENERAL DISMISSALS (RECENTLY PRESENTED TO NATIONAL ASSEMBLY) WOULD BE IMPORTANT NEXT STEP IN THIS PROCESS. PORTUGUESE INDICATED THAT THEY EXPECTED LAW TO PASS BY END OF THIS YEAR. IN THIS CONNECTION, PORTUGUESE TOOK ISSUE WITH SECRETARIAT RECOMMENDATION THAT THEY TAKE IMMEDIATE STEPS TO CLARIFY RESPECTIVE ROLES OF PUBLIC AND PRIVATE SECTORS. THEY STRESSED THAT RECENT GOVERNMENT MEASURES AND PRONOUNCEMENTS HAVE ALREADY ACCOMPLISHED THIS TASK.

6. OUTLOOK FOR 1977: GOP HAS APPARENTLY ONLY BEGUN TO FOCUS ON PROSPECTS FOR 1977. AT EDRC PORTUGUESE DELO GAVE HIGHLY PRELIMINARY ESTIMATE THAT REAL GDP MIGHT GROW BY 6-7 PERCENT NEXT YEAR, WITH PUBLIC INVESTMENT AND EXPORTS PROVIDING THE MAIN STIMULI. THEY EXPECT PRIVATE INVESTMENT AND PRIVATE CONSUMPTION TO REMAIN FLAT AND CONSUMER PRICES TO INCREASE BY 22 PERCENT.

7. BALANCE OF PAYMENTS: PRELIMINARY DATA CIRCULATED BY PORTUGAL AT EDRC INDICATE THE CURRENT ACCOUNT DEFICIT RAN AT ANNUAL RATE OF ABOUT \$1 BILLION IN FIRST HALF OF THIS YEAR. PORTUGUESE DID NOT GIVE IMPRESSION THAT GOP WAS OVERLY NERVOUS ABOUT AVAILABILITY OF EXTERNAL FINANCING. NEVERTHELESS, THEY EMPHASIZED THAT REASONABLE CURRENT ACCOUNT DEFICIT WOULD BE APPROPRIATE FOR A COUNTRY IN PORTUGAL'S STAGE OF DEVELOPMENT, AND THAT GOP

HOPED TO RELY ON MEDIUM-TERM EXTERNAL FINANCIAL ASSISTANCE TO FILL THE GAP. THEY DID NOT MAKE EXPLICIT LINK BETWEEN MAINTENANCE OF IMPORT CONTROLS AND AVAILABILITY OF FINANCIAL ASSISTANCE. PORTUGUESE ALSO INDICATED THAT LIMITED OFFICIAL USE

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THEY STOOD READY TO COMMIT ADDITIONAL GOLD AS COLLATERAL FOR FUTURE LOANS (33 PERCENT OF GOLD, VALUED AT END SEPTEMBER PRICES, IS CURRENTLY COMMITTED AS COLLATERAL. PORTUGUESE ESTIMATE VALUE OF UNENCUMBERED GOLD STOCK TO BE \$2.2 BILLION.) THEY STRESSED, HOWEVER, THAT RECOMMENDATION IN REFDOC (PARA 71) THAT GOLD STOCK BE USED FOR EXTERNAL FINANCING PURPOSES SHOULD BE REDRAFTED TO ELIMINATE IMPLICATION THAT GOP SHOULD ACTUALLY SELL GOLD.

8. EXCHANGE-RATE POLICY: PORTUGUESE ARGUED STRONGLY AGAINST SECRETARIAT RECOMMENDATIONS THAT GOP MOVE IMMEDIATELY TOWARD MORE FLEXIBLE EXCHANGE RATE. THEY REASONED AS FOLLOWS: (A) PORTUGAL HAD LET EXCHANGE RATE DRIFT DOWNWARD BEGINNING IN JANUARY 1976, BUT "LEADS AND LAGS" HAD PUT ADDITIONAL DOWNWARD PRESSURE ON ESCUDO, INDUCING GOP TO HALT DOWNWARD SLIDE IN JULY. (THUS, PORTUGUESE FELT THAT, GIVEN PRESENT CLIMATE OF UNCERTAINTY, DECLINE WOULD BE HARD TO CONTROL IF THEY WERE TO MOVE TOWARD FLEXIBILITY); (B) SINCE SHORT-RUN PRICE ELASTICITY OF IMPORTS AND EXPORTS SMALL, PORTUGUESE TRADE BALANCE WOULD IMPROVE ONLY marginally WHILE INFLATIONARY IMPACT OF DEVALUATION COULD BE SEVERE. (IN THIS CONNECTION, PORTUGUESE ALSO ARGUED THAT BECAUSE PRICE ELASTICITY OF IMPORTS AND EXPORTS IS LOW, DEVALUATION SHOULD NOT BE CONSIDERED AN ALTERNATIVE TO SELECTIVE

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IMPORT CONTROLS, AND (C) DEVALUATION OR DEPRECIATION  
WOULD BE POLITICALLY DIFFICULT.

9. DESPITE THE ABOVE ARGUMENTS, PORTUGUESE AGREED THAT  
ESCUDO WAS "STRUCTURALLY OVERVALUED," AND THAT NECESSARY  
SHIFT OF RESOURCES INTO EXTERNAL SECTOR OVER MEDIUM TERM  
WOULD BE GREATLY FACILITATED BY GRADUAL DEPRECIATION  
BEGINNING AT THE "APPROPRIATE" TIME. SECRETARIAT STATED  
THAT IT WOULD PLACE ITS RECOMMENDATION THAT GOP ADOPT AN  
"APPROPRIATE EXCHANGE RATE" IN A MEDIUM-TERM CONTEXT  
WHICH WOULD NOTE THE ROLE EXCHANGE-RATE POLICY COULD  
PLAY IN EFFECTING NECESSARY STRUCTURAL ADJUSTMENTS.  
PORTUGUESE DID NOT APPEAR TO HAVE PROBLEMS WITH THIS  
FORMULATION.

10. MONETARY POLICY: DISCUSSION ON MONETARY POLICY  
FOCUSED ON SECRETARIAT'S RECOMMENDATION THAT GOP RAISE  
LEVEL OF NOMINAL INTEREST RATES. AS IN THE CASE OF  
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EXCHANGE-RATE POLICY, PORTUGUESE FELT THAT MOVE TOWARD  
DECONTROL IN NEAR FUTURE WOULD BE INAPPROPRIATE. PORTU-  
GUESE ARGUED THAT: (A) INCREASE IN NOMINAL INTEREST  
RATES WOULD HAVE LITTLE STIMULATORY EFFECT ON DOMESTIC  
SAVINGS; FURTHERMORE, INCREASED INVESTMENT SPENDING  
WOULD ITSELF INDUCE HIGHER RATE OF SAVINGS; (B) IN  
PRESENT CLIMATE OF UNCERTAINTY, INCREASE IN INTEREST  
RATES WOULD HAVE PARTICULARLY DELETERIOUS EFFECT ON  
INVESTMENT; (C) LEVEL OF INTEREST RATE WOULD HAVE SMALL  
EFFECT ON NATURE OF INVESTMENT (LABOR VS CAPITAL INTEN-  
SIVE), SINCE LARGE PORTION OF INDUSTRY NATIONALIZED AND

NATURE OF INVESTMENT IS THUS A POLITICAL DECISION.  
(PORTUGUESE APPARENTLY NOT BOTHERED BY CONTRADICTION  
BETWEEN STATEMENTS IN (B) AND (C)); (D) CONSULTANT'S  
REPORT DONE UNDER TECO AUSPICES (FRY REPORT) APPEARED TO  
BASE ITS RECOMMENDATION FOR INTEREST RATE INCREASE ON  
BRAZILIAN AND SOUTH KOREAN EXPERIENCE. SITUATION IN  
THESE COUNTRIES NOT RELEVANT TO PORTUGUESE CASE; (E)  
WHILE INCREASE IN NOMINAL INTEREST RATES COULD ALLEVIATE  
EXTERNAL "LEADS AND LAGS" PROBLEM SOMEWHAT, RECENTLY-  
INSTITUTED IMPORT PRIOR DEPOSIT SCHEME WOULD ADDRESS  
THIS PROBLEM MORE EFFECTIVELY; (F) PORTUGUESE FIRMS HAVE  
VERY LOW SELF-FINANCING RATIOS AND HEAVY FINANCIAL BUR-  
DENS; AN INCREASE IN RATES COULD LEAD TO RASH OF BANK-  
RUPTCIES.

11. SECRETARIAT CHARACTERIZED PORTUGUESE APPROACH TO  
INTEREST-RATE POLICY AS "MEDIEVAL," BUT AGREED TO CAST  
ITS RECOMMENDATION IN MEDIUM-TERM CONTEXT. FOR THEIR  
PART, PORTUGUESE AGREED THAT FROM STRUCTURAL STANDPOINT  
OF MEDIUM-TERM ALLOCATION OF RESOURCES (I.E. CAPITAL IS  
SCARE FACTOR OF PRODUCTION), AN INCREASE IN NOMINAL  
INTEREST RATES WOULD BE IN ORDER. THEY DESCRIBED THEIR  
POSITION ON THIS QUESTION AS ONE OF "WAIT AND SEE."  
SECRETARIAT ACCEPTED PORTUGUESE VIEW AND WILL REDRAFT  
SURVEY ACCORDINGLY.

12. BUDGET: GOP GOAL IS TO REDUCE BUDGET DEFICIT AS  
PERCENTAGE OF GDP (GOP ESTIMATES 1976 DEFICIT AT 60  
BILLION ESCUDOS OR 9-10 PERCENT OF GDP). PORTUGUESE DEL  
NOTED THAT BUDGET WOULD NOT BE PRESENTED TO NATIONAL  
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ASSEMBLY UNTIL NOVEMBER 15, BUT GAVE PRELIMINARY INDICA-  
TION THAT CURRENT SPENDING MIGHT INCREASE BY 16 PERCENT  
AND CURRENT REVENUES BY 27 PERCENT, THUS HOLDING NOMINAL  
GOVERNMENT DEFICIT ON CURRENT EXPENDITURES TO 1975 LEVEL

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OF 20 BILLION ESCUDOS AND REDUCING IT IN REAL TERMS.

13. PORTUGUESE POLICY ORIENTATION: AT EDRC PORTUGUESE STRESSED THAT THEIR OBJECTIVE IS TO REALLOCATE RESOURCES AWAY FROM PRIVATE AND PUBLIC CONSUMPTION AND TOWARD INVESTMENT AND EXPORTS. PORTUGUESE INDICATED THEIR FIRM BELIEF, HOWEVER, THAT RESOURCE REALLOCATION SHOULD BE EFFECTED IN CONTEXT OF REASONABLY STRONG GROWTH OF REAL GDP. THEY THEREFORE REJECTED THE USE OF RESTRICTIVE DEMAND MANAGEMENT POLICIES TO REDUCE INFLATION OR TO REDRESS CURRENT ACCOUNT SITUATION. A FURTHER COROLLARY TO THIS POSITION IS THAT LEADING EDGE OF PORTUGUESE ANTI-INFLATION EFFORT WILL BE INCOMES POLICIES. SIMILARLY, PORTUGUESE CONSIDER SELECTIVE MEASURES TO RESTRAIN IMPORTS TO BE MORE EFFECTIVE IN NEAR TERM THAN DEPRECIATION AND CONSISTENT (AS DEFLATION IS NOT) WITH GROWTH-ORIENTED DOMESTIC APPROACH. PORTUGUESE RECOGNIZED THAT MOVE TOWARD MARKET ALLOCATION OF RESOURCES THROUGH MORE LIMITED OFFICIAL USE

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FLEXIBLE EXCHANGE-RATE AND INTEREST-RATE POLICIES WOULD FOSTER THE MEDIUM-TERM STRUCTURAL ADAPTATION THEY KNOW THEY NEED. YET THEY FELT THAT THE CONSEQUENCES OF MOVING FORWARD QUICKLY ON THESE FRONTS WOULD BE TO COMPLICATE THE PROBLEM OF ACHIEVING STABILITY IN THE SHORT RUN. EDRC ACCEPTED THIS SITUATION AS FACT OF LIFE AND DID NOT



PRESS PORTUGUESE ON EXCHANGE RATES, INTEREST RATES OR  
IMPORT CONTROLS. EDRC ALSO SUPPORTED U.S. RECOMMENDATION  
THAT REVISED DRAFT SURVEY RECOGNIZE THE SUBSTANTIAL  
PROGRESS GOP HAD MADE UNDER EXTREMELY ADVERSE CIRCUM-  
STANCES AND ENCOURAGE GOP TO PERSEVERE IN ORDERLY EFFORTS  
TO RETURN TO ECONOMIC STABILITY.

14. POINTS RAISED IN 4 AND 5 REFTEL ADDRESSED PARAS 13,  
10, 11, 5 AND 8.  
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